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DOMESTIC MACROECONOMIC RESILIENCE AMID SHIFTING GLOBAL DYNAMICS

Executive Summary

Malaysia's market outlook in 2026 is underpinned by resilient domestic demand, stable labour market conditions, and a benign inflation environment, even as external uncertainties continue to shape global financial conditions. While growth is expected to moderate, supportive macro fundamentals and policy continuity provide a stable operating backdrop for financial markets. Against this backdrop, Malaysia's bond market is well positioned to remain resilient, supported by an anchored monetary policy stance, positive real yields, and strong domestic institutional demand, which together should limit downside risks to yields. While foreign participation is likely to remain responsive to global rate cycles and shifts in risk sentiment, the lack of pronounced domestic imbalances and the presence of a credible fiscal consolidation trajectory strengthen the market's defensive appeal. Taken together, these structural supports position Malaysian bonds as a stabilising anchor within investment portfolios, particularly amid an increasingly volatile and uncertain global environment.

1. Macroeconomic Drivers & Monetary Policy

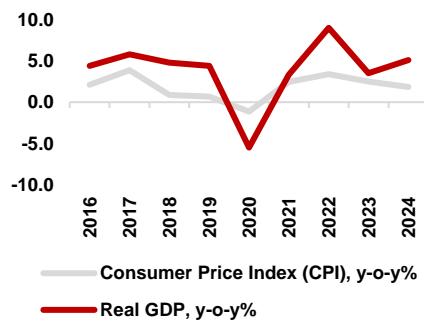
a) Sustained Growth with Stable Inflation

Malaysia closed 2025 on a strong footing, with fourth-quarter GDP growth accelerating to 5.7% according to the Department of Statistics Malaysia's (DOSM) advance estimate, comfortably surpassing market expectations of 5.4%. This late-year surge lifted full-year growth to 4.9%, exceeding the government's upper target of 4.8% and underscoring the economy's renewed momentum. Growth continued to be driven by the manufacturing and services sectors, reinforced by a tight labour market, with unemployment hitting a 10-year low of 2.9%, supporting household income and spending. While official forecasts point to a moderation in growth to the 4.0%–4.5% range in 2026 amid a more challenging external environment, including the drag from U.S. trade tariffs. Nevertheless, the domestic growth outlook remains underpinned by resilient private consumption and supportive demand-side catalysts, notably the Visit Malaysia Year 2026 initiative, which should provide a partial buffer against external headwinds.

In its January 2026 World Economic Outlook, the International Monetary Fund (IMF) upgraded Malaysia's real GDP growth forecasts for 2026 and 2027 to 4.3%—a 0.3 percentage point upward revision. Although growth is moderating from the 5.1% outturn in 2024, Malaysia continues to stand out relative to peers, outperforming a global economy expected to expand at a more subdued pace of around 3.3%. The IMF attributes this resilience to a 'balancing of divergent forces,' where trade policy headwinds are being countered by a surge in technology and A.I.-related investments across Asia.

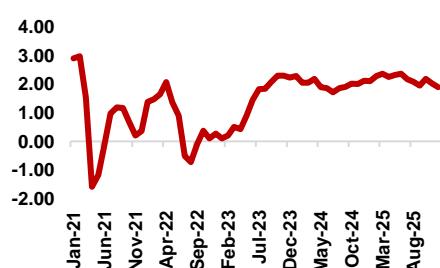
Inflation: Malaysia's 2026 inflation outlook is expected to remain benign and well-contained, with headline CPI likely averaging at 2.0%, reflecting a balance between firm domestic demand and muted cost pressures. Inflation dynamics will be shaped mainly by gradual pass-through from policy measures such as Sales and Service Tax (SST) adjustments, wage increases, and selective subsidy rationalisation and services-sector price firmness, while external cost pressures—particularly from energy and imported goods—are assumed to stay manageable.

Malaysia - CPI Inflation vs. Real GDP growth



Sources: BNM, DOSM

Malaysia - Real Yields (10Y MGS), %



Sources: BNM, DOSM

Importantly, any upside pressures are expected to be incremental rather than abrupt, allowing Bank Negara Malaysia (BNM) to maintain confidence in OPR stability in 2026. For fixed income markets, this low-inflation environment reinforces front-end yield anchoring, supports real yield attractiveness, and limits the risk of inflation-driven curve repricing, keeping inflation a secondary—rather than dominant—risk factor for bond valuations.

Monetary Stance: BNM is expected to maintain its policy rate at 2.75% throughout 2026, despite a modest projected uptick in consumer price index (CPI). By holding rates steady, the central bank aims to safeguard domestic momentum against headwinds such as geopolitical instability and slowing global trade. While the baseline forecast is a hold, the central bank retains the flexibility to pivot toward a 25-basis-point cut should domestic consumption falter or external shocks intensify. For now, the combination of a stable employment backdrop and manageable inflation supports a 'wait-and-see' approach.

Summary of Bank Islam's 2026 Macroeconomic Forecasts

Indicator	2026 Forecast	Key Drivers
GDP Growth	4.4%	Domestic consumption & tourism (Visit Malaysia 2026).
CPI Inflation	2.0%	Expected to remain benign despite subsidy rationalization.
OPR	2.75%	The central bank will likely focus on balancing growth support with a vigilant eye on inflationary risks.

Sources: Ministry of Finance (MoF), Bank Islam

2. MGS Market Outlook

a) Yield Curve Dynamics

Front end (1–3Y): Firmly anchored by OPR stability; limited volatility.

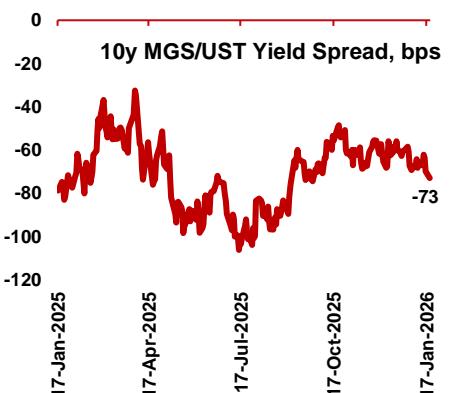
Belly (5–10Y): Most attractive segment for institutional portfolios, benefiting from roll-down and potential foreign demand.

Long end (20–30Y): Sensitive to global term premia and fiscal narratives; opportunities arise during risk-off steepening episodes.

The 2026 auction calendar reveals a clear tilt toward long-dated issuances, signalling an effort to lock in funding at longer maturities while aligning supply with sustained demand from pension funds and insurers.

Tenor Bucket	Number of Auctions	%
Short-Term (3Y – 3.5Y)	6	16.2
Medium-Term (5Y – 7Y)	8	21.6
Benchmark (10Y)	6	16.2
Long-End (15Y, 20Y, 30Y)	17	46.0
Total	37	100

We expect the 10-year MGS yield to close around 3.40% by end-2026 (2025: 3.49%), reflecting a stable OPR at 2.75%, benign inflation averaging at around 2.0%, and a normalisation of term premia rather than renewed expansion. At



Sources: Federal Reserve Board, DOSM

this level, real yields remain meaningfully positive, supporting sustained domestic institutional demand, while foreign participation remains opportunistic rather than structural. The forecast implies neither aggressive easing nor fiscal stress, but a steady-state equilibrium consistent with Malaysia's macro and policy environment.

b) Supply-Demand Dynamics

Maturity Peak: 2026 faces a massive maturity wall of roughly RM108.7 billion in MGS and GII.

2026 Government Bond Maturities

Maturity date	Stock	RM billion
31-Mar-26	MGS 1/2018 3.882% 14.03.2025	25.5
15-Apr-26	MGS 3/2005 4.837% 15.07.2025	8.4
15-Jul-26	GII MURABAHAH 1/2018 4.128% 15.08.2025	20.0
15-Sep-26	MGS 1/2015 3.955% 15.09.2025	2.3
30-Sep-26	GII MURABAHAH 4/2015 3.990% 15.10.2025	29.5
30-Nov-26	MGS 1/2015 3.955% 15.09.2025	23.0
Total Maturity		108.7

Source: Bloomberg

Issuance: While gross issuance is projected to reach RM185 billion to cover these maturities, net supply will be lower than in 2025. This scarcity of "new" debt, coupled with high reinvestment demand from local institutional funds will cap yields from trending higher.

Issuance activity is slightly front-to-mid-loaded, with the highest concentration of auctions occurring in the second and third quarters.

1Q2026: 9 issuances (Average of 3 per month).

2Q2026: 10 issuances.

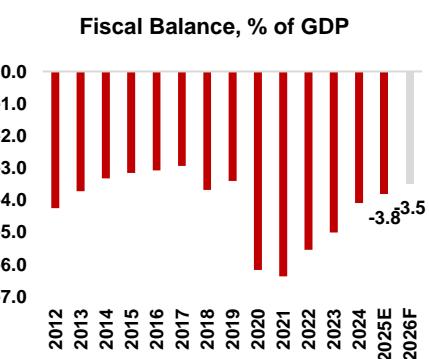
3Q2026: 10 issuances.

4Q2026: 8 issuances (Tapering off toward year-end).

3. Fiscal Commitment

The government remains committed to fiscal consolidation, with the fiscal deficit projected to narrow to 3.5% of GDP in 2026 from an estimated 3.8% in 2025. Consistent with the expected debt maturity profile and consolidation objectives, gross MGS/GII issuance is projected at RM180.0–185.0 billion in 2026. This issuance will largely be directed toward refinancing RM108.7 billion of maturing debt (MGS: RM46.5 billion; GII: RM59.2 billion) and to fund the projected RM74.6 billion fiscal deficit, an improvement from RM76.7 billion in 2025.

Under the Public Finance and Fiscal Responsibility Act 2023, overall government debt is capped at 60% of GDP in the medium term, while government guarantees are limited to 25% of GDP. With headline debt still above the statutory ceiling, the government is expected to make measured use of remaining GG headroom to support financing needs while gradually lowering the official debt ratio toward its medium-term target.



Source: MoF

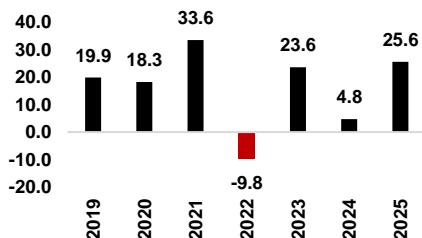
4. Foreign Flows

Foreign demand for Malaysian bonds will remain closely tied to movements in UST yields and global term premia. A stabilisation or decline in UST yields would be conducive to renewed carry-seeking inflows into MGS, particularly from real-money investors. Conversely, renewed upward pressure at the long end of the UST yield could trigger duration-sensitive outflows, even in the absence of domestic stress. As such, foreign flows are more likely to amplify global-driven market dynamics rather than reflect shifts in Malaysia-specific fundamentals.

Drivers of inflows: Stable sovereign fundamentals, positive real yields, and ringgit stability.

Constraints: Sensitivity to U.S. interest rate volatility and global risk sentiment.

Cumulative Net Foreign Flows in Local Bonds
(Yearly Comparison, RM Billion)



Source: BNM

Key Risks to Monitor

a) *Abrupt shifts in U.S. monetary policy expectations*

A faster-than-expected re-pricing of U.S. monetary policy, either due to sticky inflation, stronger growth, or political interference concerns could push UST yields higher and steepen global curves.

Transmission to Malaysia FI:

- Upward pressure on long-end MGS yields via higher global term premia
- Temporary foreign outflows, particularly from 10Y and ultra-long MGS
- Curve steepening driven by external rather than domestic factors

What to monitor:

- U.S. inflation surprises
- Fed communication around neutrality and balance-sheet policy
- Term premium indicators and UST curve steepening episodes

b) *Renewed global risk-off episodes or geopolitical shocks*

Escalation in geopolitical tensions or renewed trade restrictions could disrupt global supply chains and weaken external demand.

Transmission to Malaysia FI:

- Risk-off flows pushing yields higher temporarily
- Pressure on export-linked corporates and sectors
- Increased FX volatility affecting foreign participation

What to monitor:

- Developments in major trade corridors (U.S.–China, Middle East)
- Commodity price volatility (especially energy)
- Global Purchasing Manager's Index (PMI) and trade volume indicators

c) *Domestic policy surprises affecting subsidies, taxation, or regulated prices*

Unexpected changes to subsidy frameworks, taxation, or off-budget liabilities could alter fiscal expectations and investor confidence.

Transmission to Malaysia FI:

- Re-pricing of long-dated bonds due to higher fiscal risk premia
- Steepening of the curve if deficit expectations widen
- Reduced foreign appetite for duration exposure

What to monitor:

- Budget updates, supplementary spending announcements
- Subsidy rationalisation pace and political resistance
- Government-linked entity (GLE) contingent liabilities

d) Inflation Re-acceleration from Domestic Price Adjustments

Although baseline inflation is benign, risks remain from administered price reforms (fuel, utilities, food) or supply-side disruptions.

Transmission to Malaysia FI:

- Front-end repricing if inflation expectations rise
- Reduced confidence in prolonged OPR stability
- Curve flattening if markets price future policy tightening

What to monitor:

- Announcements on fuel subsidies and price ceilings
- Food inflation trends and climate-related supply shocks
- Core inflation momentum vs headline prints

Conclusion

Malaysia's fixed income market offers stability rather than aggression. Institutional investors and portfolio managers are best positioned by emphasising carry efficiency, disciplined duration management, and maintaining strong credit quality. While potential upside remains limited, downside risks are well contained, reinforcing Malaysian bonds' role as a defensive anchor within regional investment portfolios.